

October 30, 2003

**To the Honorable Mayor and Members of the City Council
City of Durham, North Carolina**

The Comprehensive Annual Financial Report (CAFR) of the City of Durham (City) for the fiscal year ended June 30, 2003 (FY 2002-03) is hereby submitted. As required by North Carolina General Statutes (NCGS), the CAFR includes financial statements that have been audited by an independent certified public accounting firm. Responsibility for the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the City. To the best of our knowledge and belief, the enclosed data accurately presents the financial position and the results of operations of the City as measured by the financial activity of its various funds. All disclosures necessary to enable the reader to gain an understanding of the City's financial activities have been included.

The CAFR is presented in five sections: Introductory, Financial, Accompanying Financial Schedules, Statistical, and Single Audit. The Introductory Section includes this letter of transmittal, an organization chart, and a copy of the Certificate of Achievement for Excellence in Financial Reporting. The Financial Section contains the Independent Auditor's Reports, combined statements, notes to the financial statements, and more detailed combining and individual fund statements and schedules. The Accompanying Financial Schedules includes selected unaudited schedules related to budget, taxes, assessments, and debt. The Statistical Section provides selected financial and general information. The Single Audit Section includes the Independent Auditor's Reports on internal controls and compliance with laws and regulations, and a schedule of expenditures of federal and state awards. This section has been prepared in accordance with the provisions of the Single Audit Act, U.S. Office of Management and Budget Circular A-133 and NCGS 159-34.

The financial reporting entity includes all of the City's funds. Component units are legally separate entities for which the City has financial control. Financial control by or dependence on the City is determined on the basis of budget adoption, taxing power, outstanding debt secured by the revenues or general obligation of the City, or the obligation of the City to finance any deficits or receipt of significant subsidies from the City. Based on these criteria the City does not have any discretely presented component units. Blended component units are legally separate entities; however, in substance, their operations are included as part of the primary government.

GAAP require that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis

(MD&A). This letter of transmittal is designed to complement MD&A and should be read in conjunction with it. The City of Durham's MD&A can be found immediately following the report of independent auditors.

PROFILE OF THE CITY OF DURHAM

Durham is a city nestled on the rolling hills of central North Carolina. It is the fourth largest city in the state, the county seat, and the only municipality in Durham County. The city takes pride in its educational, cultural, athletic, and medical assets. Durham covers an area of 98.2 square miles. The estimated population of 195,231 includes a rich diversity of racial and ethnic backgrounds.

The City of Durham has operated under the Council-Manager form of government since 1921. Durham City Council is comprised of seven members: three members from specific wards, three at-large members, and the Mayor. The terms for City Council seats are staggered, and nonpartisan elections are held every two years. The ward members elected in 2001 serve a four-year term. The at-large seats filled in 2001 will be contested in 2003, and those elected in 2003 will serve a four-year term. City Council is the legislative and policy-making body for Durham and is the final authority on most matters relating to the City. The Council is responsible for establishing general policies for the City; appointing the City Manager, City Attorney, City Clerk, and members of various boards and commissions; enacting ordinances, resolutions and orders, reviewing the annual budget, and authorizing contracts on the City's behalf.

The Mayor serves as presiding officer of the City Council and votes on all matters that come before the body. The Mayor also appoints standing and special committees of the Council, unless the Council votes to elect such committees. As official head of city government, the Mayor represents the City on ceremonial occasions. The City Manager is the administrative head of city government and is responsible for the efficient management of City operations. The Council appoints the Manager, who ensures that ordinances and policies set by Council are carried out. The Manager is also responsible for preparing the annual budget and for supervising city departments and personnel (except the City Attorney's and City Clerk's offices). As an employee of the City Council, the Manager normally attends all Council meetings.

City government services are headquartered at Durham's City Hall in downtown Durham. Service facilities including police and fire stations, recreational facilities, and public works operations, can be found throughout the community.

The City of Durham's annual budget process, the framework for communicating major financial operational objectives and for allocating resources to achieve them, is a complex undertaking involving the whole government. The process begins in October and runs until the end of June. By State law, the City must adopt an annual budget ordinance by June 30th of each year. As part of the budget process the City Council holds two public hearings on the budget, one in January at the beginning of the budget process and one in June prior to adoption as mandated by State law. City departments are required to submit budgets to the City Manager in March and those requests are used as a starting point for the development of a preliminary budget to be presented to City Council.

Once the budget is approved, the focus of the budget is upon control. Ongoing monitoring of expenditures and revenues throughout the year is a responsibility shared by department directors and the Budget Department. The Accounting Services Division of the Finance Department ensures that changes are correctly entered and payments are appropriate.

The Budget and Management Services Department reviews all requests from departments to make sure that sufficient appropriations have been budgeted. All funds are reviewed on a regular basis, and a budget report is submitted to the City Council on a quarterly basis.

The City Manager has the authority to transfer budgeted amounts between departments within any function. However, transfers between functions, additions, or deletions require a budget amendment. To amend the budget, a revised budget ordinance must be approved by the City Council.

Budget to actual comparisons are provided in this report for each individual governmental fund for which an appropriated annual budget has been adopted. For the General Fund, this comparison is presented on page 25 as part of the basic financial statements for the governmental funds. For governmental funds, other than the general fund, with appropriated annual budgets, this comparison is presented in the governmental fund subsection of this report, which starts on page 76.

FACTORS AFFECTING FINANCIAL CONDITION

Regional Picture: The Raleigh-Durham-Chapel Hill Metropolitan Statistical Area (MSA) has one of the strongest, most stable economies in the nation. National magazines consistently give the region top rankings for quality of life, higher education, overall business climate, small business and entrepreneurial opportunities, business climate for women, and combining work and family life. In June of 2002, Employment Review rated the area as the #1 Best Place to Live and Work in America.

Location and Accessibility: The City borders the Research Triangle Park (RTP) on three sides. RTP, recognized internationally as a center for cutting-edge research and development, is the largest research park in the United States. RTP covers over 6,900 acres and is home to more than 137 organizations employing approximately 38,000 people. Durham is centrally located among the major population centers of the East Coast, and is bisected by Interstates 85 and 40, which are connected by the Durham Freeway. Raleigh-Durham International Airport (RDU), located just east of the City limits, served over 8.3 million passengers and moved 118,229 tons of cargo in 2002. RDU is served by 9 major airlines, providing non-stop service to 37 cities.

Employment Base in Research and Manufacturing: The City's diverse and expanding economy is rooted in electronics, health care, medical research, education, and telecommunications. The "City of Medicine" is one of the nation's leading centers for biotechnology and medical research. Of the State's 137 biopharmaceutical companies, 62 are located in Durham County. North Carolina Central University's Biomedical/Biotechnology Research Center (BBRI) received two major grants awards for research on minority health and to establish a NASA Center for Excellence at BBRI. Duke Medical School is ranked the 4th Best Medical School in the Country for Research and Duke Hospital is ranked 6th Best Hospital in

the Country by U.S. News. Duke University and Duke Medical Center employ 20,000 people, while spin-offs from research at Duke, the University of North Carolina at Chapel Hill, and North Carolina State University, have created dozens of start-up biotech firms. These companies are supported by the state-sponsored North Carolina Biotechnology Center, located in Research Triangle Park.

Ninety-five percent of the companies currently operating in Research Triangle Park are located in Durham County. RTP employs over 38,000 people in such leading firms as IBM, GSK, Cisco Systems, Nortel Networks, BASF, and Sumitomo. Another 50,000 people are employed at the numerous manufacturing facilities, office parks, and flex buildings located in the City just outside of RTP, complementing the research and development activities inside the Park.

Treyburn Industrial Park in northern Durham County employs 2,000 people in firms including Becton-Dickinson, Organon Technika, Cormetech, and Fruedenberg. Despite the City's reputation as a center of research and development activities, Durham is one of the few areas in the Country where both the size and percentage of the manufacturing workforce is increasing as well.

Unemployment in Durham has averaged 3.4 % over the past five years, and has been consistently below the state and national averages. After reaching a record-low of 1.9% in 1999, unemployment increased to a five-year high of 6.2% in 2002, which was still significantly lower than the State level of 7.0%. For fiscal year 2003 Durham County unemployment dropped to 5.6%, signaling a slight rebound in local hiring.

Education and Job Training: The education and skill level of the labor force is a major factor in the desirability of the Durham area. Over 35% of Durham County adults possess at least a Bachelor's degree, compared with 20% nationally. The community college system - particularly the system's interaction and cooperation with businesses to establish training programs - is regarded as one of the best in the nation. In-migration continues to add to the work skills and brainpower needed by our growing companies.

Construction Trends: The City continues to witness strong and solid levels of private investment, with values of building permits totaling more than \$ 740 million in fiscal year 2003. This represents a 32% increase over the previous year. Downtown Durham is targeted as an area of particular strategic and symbolic importance, and has seen such recent successes as the 250-unit West Village apartments (a renovation of historic tobacco industry buildings), the expansion of the Durham Bulls Athletic Park, renovation of the 1904 TeerMark office building, and the fully leased, 90,000 square foot Diamond View office building. In April of 2003 the City entered into a public/private partnership with Durham County and Capital Broadcasting for the historic redevelopment of the American Tobacco Complex. When completed this project will include more than 900,000 square feet of office and mixed use space and will bring 3,600 jobs to the downtown area. Construction has begun on the first phase, which includes 400,000 square feet of office space and two publicly financed parking garages, is scheduled for completion in Spring of 2004. Outside of downtown, Urban Retail Properties completed construction of the \$220 million Streets at Southpoint Mall, which opened in March 2002. Also, the redevelopment of the South Square Mall is underway and should be completed in Spring of 2004.

The City is currently negotiating several public/private partnerships related to major development projects in the downtown area including the following:

- Developing the former Woolworth's site on historic Parrish Street
- Planning a downtown entertainment district featuring a 4,200 seat theater
- Redeveloping the Liggett & Meyers tobacco manufacturing and warehouse facility
- Constructing a second tower at the Renaissance complex for residential condominiums.

MAJOR INITIATIVES

For the Year 2003-04

The FY 2003-04 Budget reflected the following community goals that were adopted by the City Council:

- To improve the quality of life by reducing the incidence of crime.
- To improve the quality of life by addressing the root causes of crime.
- To improve the quality of life by ensuring the availability of, and access to, adequate, safe, and affordable housing for every resident.
- To provide economic development activities that increase citizen access to high quality jobs while increasing the City's tax base.
- To improve the livability of the City by managing the City's growth, protecting and preserving the environment, and maximizing the use of public infrastructure.
- To improve the City's image by preserving and enhancing the community's aesthetic beauty and natural assets, and by building upon the rich and diverse cultural heritage of the community.
- To maximize the efficient and effective management of and accountability for the City's financial resources.

FINANCIAL INFORMATION

General Fund Balance

The City Council has adopted a policy of maintaining an undesignated fund balance of no less than 12% of budgeted appropriations, adjusted for debt service and transfers to other funds. The FY 2003 undesignated fund balance is 10% of FY 2003 budgeted appropriations adjusted for debt service and transfers to other funds. The decision to allow fund balance to drop below the 12% target was due to the lingering effects of the loss of state shared revenues and the slow economy. Budgetary projections show fund balance reaching the 12% level during the five-year planning horizon.

Cash Management

Effective forecasting of cash requirements and progressive cash management has allowed the maximum use of all available cash resources. For the year ended June 30, 2003, the City's gross investment income was \$5,025,208, which is an adjusted decrease of \$1,976,278 from the previous fiscal year. This amount includes a GASB Statement 31 market value increase in the amount of \$470,143. The City's average weighted yield to maturity for the pooled cash at June 30, 2003, was 4.03%.

The City uses the pooled cash and investment concept in investing excess cash for all funds. The goal of the City's investment policy is to minimize credit and market risk while receiving high returns on investments. The investment policy of the City is guided by NCGS 159-30, which stipulates that the City can only invest in certificates of deposit, repurchase agreements, secured time deposits, banker's acceptances, commercial paper, and United States government and agency securities.

Risk Management

The City has established Risk Management programs to (1) identify potential exposure to loss, (2) evaluate the frequency and severity of losses, (3) determine the most efficient use of financial resources to pay for losses that are not preventive, (4) reduces or eliminates risks or losses through procedures and practices. Additional information relative to insurance coverage and risk retention is presented in the Notes to the financial statements.

OTHER INFORMATION

Independent Audit

State Statutes require an annual audit by independent certified public accountants. The accounting firm of Cherry, Bekaert & Holland was selected by the City Council. In addition to meeting statutory requirements, the audit also complies with the Federal Single Audit Act, Office of Management and Budget Circular A-133, and NCGS 159-34 (Single Audit Implementation Act). The auditor report on the general-purpose financial statements and combining and individual fund statements and schedules are included in the financial section of this report. The auditors' reports on internal controls and compliance with applicable laws and regulations are included in the Single Audit Section.

Awards and Acknowledgements

The Government Finance Officers Association of the United States and Canada (GFOA) once again recognized the City for the quality of its Comprehensive Annual Financial Report issued for the previous fiscal year. In order to be awarded a Certificate of Achievement, the City must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and accepted legal requirements. This Certificate of Achievement for Excellence in Financial Reporting marks the 18th consecutive year and the 22nd time in 24 years that the City has been so honored.

A Certificate of Achievement is valid for a period of one year only. We believe that our current report continues to conform to the Certificate of Achievement Program requirements, and we are submitting the report to GFOA to determine its eligibility for another certificate.

In addition, the City of Durham also received the GFOA's Distinguished Budget Presentation Award for its annual budget document for the fiscal year beginning July 1, 2002. In order to qualify for the Distinguished Budget Presentation Award, the City of Durham's budget document was judged to be proficient in several categories, including as a policy document, a financial plan, an operations guide, and a communications device.

Preparation of this report would have been impossible without the hard work and dedication of the Department of Finance Staff. In particular the efforts of the Accounting Staff and the Financial Reporting Team should be recognized. Other departments of the City have also contributed directly or indirectly in the preparation of this report and their cooperation and continued assistance is appreciated.

We also greatly appreciate the ongoing support and guidance we receive from the Mayor and the City Council.

Respectfully submitted,

Marcia L. Conner
City Manager

Kenneth C. Pennoyer
Director of Finance